



Roth IRA May Not Be Best Choice for Many

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Roth IRA is an attractive alternative

The new Roth IRA holds many attractive advantages, but is it better than a deductible IRA or other deductible retirement plans such as the 401(k) and 403(b)? The results of my analysis may surprise you. First, let us list the undeniable attractions of a Roth IRA:

- Nondeductible contributions of up to \$3,000 per year (\$3,500 if age 50 or older) grow tax-deferred.
- Tax-free withdrawals can be made after five years and age 59 1/2 or withdrawal meets one of three conditions: up to \$10,000 used for first-time home buying expenses; used for qualified higher education expenses; or taken upon death or disability of taxpayer.
- Contributions can be made after age 70½.

The Roth IRA also allows taxpayers to make unscheduled or lump-sum contributions to their accounts. It also enables taxpayers who are not eligible for a deductible IRA or other deductible retirement plan to save and invest tax-free. What could be better?

Deductible plans have advantages

Although traditional IRAs offer fully deductible and partially deductible contributions only to taxpayers who fall within certain income ranges, many taxpayers have access to other deductible retirement plans, such as the 401(k) and 403(b). Should taxpayers who have access to any of these deductible retirement plans choose them over a Roth IRA? The answer is it depends primarily on your tax bracket before retirement versus during retirement. In Hawaii, this factor is magnified by the fact that pension withdrawals are not taxed by the state.

Deductible retirement plans allow taxpayers to use pretax dollars for their contributions. The earnings grow tax-deferred but are then taxed along with the untaxed contributions when withdrawn. The magic of these retirement plans comes from the fact that taxpayers can contribute more pretax dollars to an account than they can taxed dollars at an equivalent cost. And this enables them to put



more principal to work. It is as though you rented a larger machine to produce widgets. Even though you will eventually be taxed on the rented machine and the widgets it produces, if you produce enough extra widgets you will make out better than the person who used a smaller widget-making machine to produce tax-free widgets.

Deductible plans better for many

The exact benefit of using a deductible retirement plan versus a nondeductible plan depends on your exact tax bracket before retirement versus during retirement. In general, anyone who is in a higher overall tax bracket before retirement than during retirement, will make out better with a deductible plan and will benefit from using and maxing out deductible options before using the Roth option. For example, a combined federal and state tax bracket of 38% before retirement coupled with a federal only tax bracket of 15% or 28% during retirement would provide respectively a 37% or 16% greater after-tax distribution for a deductible IRA over a Roth IRA. If Hawaii begins taxing pension distributions, the advantage would drop from 37% to perhaps 29% (depending on the exact lower retirement bracket) and from 16% to 0% for the higher bracket.

On the other hand, if you are in the same tax bracket during retirement as before, you will break even. And if you are in a higher tax bracket during retirement than before, you will benefit more from a Roth IRA over a deductible plan.

For example, a tax bracket of 20% before retirement coupled with a federal only tax bracket of 15% or 28% during retirement would produce a 6% advantage for the deductible plan over the Roth IRA at the 15% bracket and a 10% disadvantage at the 28% bracket. Instituting a state tax that might increase the 15% to 20% and the 28% to 38% would nullify the 6% advantage and increase the 10% disadvantage to a 23% disadvantage. Surprisingly, these findings were true regardless of the rate of earnings or the length of period before and during retirement.